Internal Revenue Service

memorandum

CC:TL-N-5097-90
Br.4:MEHara

date: APR 09 1990

to: District Counsel, Manhattan CC:MAN

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: [redacted]

This is in response to your March 23, 1990 request for formal tax litigation advice in the above-entitled matter. You seek our advice on whether the Service may deny the taxpayer's tentative net operating loss carryback under the circumstances of this case.

ISSUE

Whether the Service must allow taxpayer's tentative NOL carryback application if the statutory and regulatory requirements in I.R.C. § 6411 and the Treasury Regulations thereunder, as amplified by Rev. Rul. 78-368, 1978-2 C.B. 324, are satisfied.

CONCLUSION

While the Internal Revenue Code provides for no sanctions if the otherwise proper tentative NOL carryback application is not acted upon by the Service, the fact that the taxpayer is under Chapter 11 bankruptcy court supervision and has another United States creditor leads us to conclude that, assuming no way can be found to otherwise disallow the claimed tentative allowance, the overpayment ought to be made under bankruptcy court supervision for the benefit of the United States creditor.

FACTS

The available facts may be summarized as follows. [redacted] filed an application for a tentative NOL carryback loss on [redacted], carrying back a [redacted] operating loss of some $[redacted] to [redacted] and [redacted] filed for bankruptcy court protection on [redacted]. It appears that a substantial portion of the [redacted] operating loss is attributable to the taxpayer's brokerage business; part of the loss may stem from the civil settlement paid by [redacted] to another United States Government agency, the Securities and Exchange Commission. We understand from newspaper articles and from talking with attorneys in your office that the SEC has not yet been paid in full. Allegations of excessive compensation to brokers by [redacted] have been made by third parties. While [redacted] filed consolidated returns with

its subsidiaries for the periods under consideration, the subsidiaries did not file for bankruptcy. Because of the possibility of an early bar date in the bankruptcy court, the Examination Division is expediting the examination of [redacted] 's [redacted] tax year. The tentative NOL carryback allowance request is proper and but for the unusual posture of the taxpayer, would be allowed.

DISCUSSION

Section 6411

I.R.C. § 6411(a) provides that a taxpayer who has a net operating loss may file an application for a tentative carryback adjustment. I.R.C. § 6411(b) provides that the Service shall make "a limited examination of the application, to discover omissions and errors in computation," and shall determine the amount of the decrease in tax attributable to the carryback. The examination shall be made within 90 days from the date on which the application for tentative carryback application is filed or from the last day of the month of the last date for filing the return for the taxable year of the loss from which such carryback occurs, whichever is later. I.R.C.§ 6411(b) further provides that the Service may disallow, without any further action, any application which it finds contains either material omissions or errors of computation which it deems cannot be corrected by him within the 90 day period. Treas. Reg. § 1.6411-2(b) provides that in determining the decrease in tax which is affected by the carryback, it shall be assumed that tax items reported in the taxpayer's return were correctly reported.

I.R.C. § 6213(b)(3) provides that if it is determined that the amount applied, credited, or refunded under I.R.C. § 6411 is in excess of the overassessment properly attributable to the carryback upon which the application was based, the District Director may summarily assess an amount equal to the excess without following the deficiency procedures as if the excess were due to a mathematical or clerical error appearing on the return. Treas. Reg. 301.6213-1(b)(2). I.R.C. § 6213(b)(3) consequently creates a symmetry which balances the taxpayer's right to a "quickie" refund against the Service's authority to summarily make an assessment, by providing a summary procedure whereby the Service and the taxpayer each can be restored to the position occupied prior to the approval of the application for tentative carryback adjustment.[1]

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[1] See, H.R. Rep. No. 849, 79th Cong., 1st Sess. (1945), 1945 C.B. 566, 583.

Current Service Position

Originally, the Service took the position that allowance of a tentative carryback under I.R.C. § 6411 was not mandatory in bankruptcy or jeopardy cases. For example in [redacted], GCM 25,604 (March 9, 1948), the Service concluded that a tentative refund may be disallowed if it appeared that collection would be in jeopardy if it were subsequently determined that the refund had been excessive. GCM 25,604 also held that jeopardy would exist in most, if not all cases where the taxpayer is under the jurisdiction of a bankruptcy court. However, [redacted] GCM 36,521 (December 19, 1975) specifically revoked GCM 25,604, and the current Service position as reflected in Rev. Rul. 78-369, 1978-2 C.B. 324 is that an application for a tentative refund from the carryback of a net operating loss timely filed must be allowed, provided the application contains no material omissions or errors of computation. The taxpayer is entitled to a credit or refund on the application even if a deficiency has been proposed exceeding the amount of the tax plus the amount of the loss, and even if the 90 day period prescribed in I.R.C. § 6411(b) had expired.[2]

Treas. Reg. § 1.6411-3(c) provides that the Service's action in disallowing, in whole or in part, any application for a tentative carryback adjustment shall be final and may not be challenged in any proceeding. The taxpayer may, however, file a claim for refund.

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[2] The mandatory nature of I.R.C. § 6411 was examined in Tentative Refunds from Carryback of Net Operating Losses, GCM 36,575 (February 6, 1976), where the issue was whether an application for a tentative carryback may be disallowed because the carryback year was before a court. G.C.M. 3657 concluded that:

> The allowance of an application for a tentative carryback adjustment is mandatory under Code section 6411(b) unless the application contains errors of computation which cannot be corrected within the 90-day processing period or material omissions. We are unable to find anything in the Code, regulations, or legislative history underlying Section 6411 to support the position that an application may be disallowed due to the pendency of the carryback year before a court.

Consequence of Failure to Make Refund

While I.R.C. § 6411 provides that the Service must make the refund absent material omission or mathematical error, there is no statutory sanction if the Service does not do so.[3] In Zarnow v. Commissioner, 48 T.C. 213 (1967), the Service failed to act on the tentative carryback application within 90 days. Based on that inaction, the petitioner argued that the Service was barred from determining a deficiency for the loss year. Since I.R.C. § 6411 contains no sanction for inaction and the Service's action in any event is merely tentative and not final, the Tax Court concluded that "we can find no indication that the missing sanction is to be provided by holding that such a failure to act prevents [the Commissioner] from determining a deficiency for the year of the alleged loss." 48 T.C. at 215. Similarly, in Pesch v. Commissioner, 78 T.C. 100, 115 (1982) the Tax Court stated "[n]either section 6411 nor the regulations promulgated thereunder impose any sanction against respondent for his failure to act within the 90 day period." See also Thrif-Tee, Inc. v. United States, 492 F.Supp. 530 (W.D.N.C. 1979), aff'd unpub op., 628 F.2d 1351 (4th Cir. 1980), cert. denied, 449 U.S. 1124, (1981)(the Service's inaction on a tentative carryback allowance would not justify a refund suit based on an untimely filed claim for refund) and Blansett v. United States, 283 F.2d 474 (8th Cir. 1960)(no statutory authority for enjoining the Service's action in disallowing a tentative carryback, even if the disallowance was improper).

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[3] Saltzman, IRS Practice and Procedure, § 11.03 (New York 1981, Cumm. Supp. 1987) states that if the application is disallowed, the taxpayer's remedy is to file a "regular claim for refund." A Lexis search has located no cases dealing with whether or not a mandamus action under 28 U.S.C. § 1361 would lie to force the Service to refund or credit the tentative allowance under I.R.C. § 6411. Mandamus is an extraordinary remedy and applies only where there is: (1) a clear right to the relief sought, (2) a peremptory or ministerial duty on the part of the Service to grant it and (3) no other remedy exists. Mandamus is not available where the petitioner has not exhausted his administrative remedies. Taranto v. Commissioner, 76-2 U.S.T.C. ¶ 9603 (E.D.N.Y. 1976). While mandamus has been held applicable to compel federal officials to pay tax monies out of the federal treasury in an overpayment context, Vishnevsky v. United States, 581 F.2d 1249 (7th Cir. 1978); First Federal Savings v. Baker, 88-2 USTC ¶ 9571 (4th Cir. 1988), the absence of a refund suit remedy was critical to the result in those cases. A refund suit is an appropriate remedy. Taranto, supra; see also Lovallo v. Froehlke, 468 F.2d 340 (2d Cir. 1972).

Service Action in Abusive Tax Shelter Area

The issue of under what circumstances an I.R.C. § 6411 tentative refund may be withheld in the context of abuse tax shelter was examined by the Service during the early 1980's. The Service in that instance was concerned that shelter investors were requesting "quickie" refunds as a result of an investment credit carryback, in effect, financing the shelter with refund dollars. In a memorandum dated June 2, 1982, a copy of which is attached for your information, the Chief Counsel's office reviewed I.R.C. § 6411, its legislative history and the regulations and administrative interpretations and concluded that "we do not believe, even in an egregious [tax shelter] situation, that the rather clear purport section 6411(b) should be disregarded. Consequently, we conclude that the applications must be allowed."

Because of the mandatory nature of I.R.C. §6411(b) and anticipated problems envisioned by merely withholding or freezing the refund, it was suggested that if the Service determined that the amount scheduled to be refunded was in excess of the overassessment properly attributable to the carryback, it schedule the refund and simultaneously use the assessment procedure provided in I.R.C. § 6213(b)(3) to prevent payment of the refund to the taxpayer, as described below.

Under this approach which is discussed in [redacted] GCM 39,318 (December 26, 1984), the Service schedules the tentative refund, assesses an amount attributable to the abusive tax shelter under I.R.C. § 6213(b), and offsets the amount assessed against the scheduled refund, all within the 90 day period provided under I.R.C. § 6411(b). This approach treats scheduling the tentative refund as an allowance of the tentative refund and the amount allowed as the amount applied, credited or refunded under I.R.C. § 6411. GCM 39,318 argued that support for this treatment was provided by I.R.C. § 6407 which states that the date on which the Service first authorizes the scheduling of an overassessment is the date of the allowance of a refund or credit, citing United States v. Swift & Co., 282 U.S. 468 (1931), and Rahr Malting Co. v. United States, 157 F.Supp. 803 (E.D. Wisc. 1957), aff'd 260 F.2d 309 (7th Cir. 1958). The Service adopted this approach in Rev. Rul. 84-175, 1984-2 C.B. 296, concluding that in abusive tax shelter situations, the Service may allow and assess the tentative carryback adjustment in situations subject to the penalty under I.R.C. § 6700 (relating to the penalty for promoting abusive tax shelters).

Although a similar mechanism is theoretically available in the [redacted] situation, its use would require an offsetting assessment. A notice of deficiency by itself would be insufficient. Furthermore, the existence of the bankruptcy bars the Service from making an assessment absent the lifting of the automatic stay.

Setoff of Refund Against Debt Owed to Another Agency

Despite the holding in GCM 36,521 and Rev. Rul. 78-369, 1978-2 C.B. 324, the Service, however, may offset a I.R.C. § 6411 tentative carryback refund against a debt that the taxpayer owes to another governmental agency. In Belgard v. United States, 282 F.Supp. 265 (W.D.La. 1964), the court held that I.R.C. § 6411(b) did not bar the government from offsetting the amount of the tentative carryback refund against a debt due another agency. In Belgard, the taxpayer filed an application for a tentative carryback adjustment in which he sought to carryback a net operating loss. Within the 90 day period, the taxpayer was informed that the Service was going to allow the loss carryback, but that amount would be offset against a debt due another Government agency, the Small Business Administration. The taxpayer was notified of the offset in writing. Thereafter, the District Director scheduled the amount claimed in a tentative carryback application for payment. Although the claim had been allowed, no check was drawn in favor of the taxpayer. Instead, a voucher was prepared scheduling payment of the refund amount to the Small Business Administration. The Belgard court held that "the Government has the right - which belongs to every creditor - to apply the unappropriated monies of its debtor, in its hands, in extinguishment of amounts due that debtor." Id. at 268. The court examined the language of I.R.C. § 6411 and stated that its language did not bar offsetting the tentative carryback refund amount against any debt other than a tax debt.

Similarly, in [redacted] GCM 35,517 (December 19, 1975), the Service determined that a tentative refund due to a taxpayer could be setoff against a debt owed to the Small Business Administration. The Service reasoned that the history and regulations underlying I.R.C. § 6411 which prescribe specific rules governing the treatment of tentative adjustments between the Service vis-a-vis the taxpayer do not have any bearing on whether a tentative refund may be setoff against the claim of another agency. GCM 35,517 also concluded that it was not necessary that the claim of the creditor agency be reduced to a final judgment, as long as the debt is liquidated or certain in amount.

In the [redacted] situation, it appears that a portion of the tentative NOL carryback may be applied to the amount due to the Securities and Exchange Commission pursuant to the taxpayer's civil settlement agreement. Under the authority of Belgard and GCM 35,517, it is clear that absent the bankruptcy proceeding, the tentative carryback refund amount could be immediately offset in whole or in part against the amount still owing to the Securities and Exchange Commission.

The Effect of the Bankruptcy Proceeding

On [redacted], [redacted] filed a chapter 11 petition in bankruptcy. Under 11 U.S.C. § 362(a), the filing of a bankruptcy petition results in an automatic stay against creditors, preventing:

"(6) any act to collect, assess or recover a claim against the debtor that arose before the commencement of the case . . .
(7) the setoff of any debt owing to the debtor that arose before the commencement of the case . . . against any claim against the debtor".

The automatic stay provisions of the Bankruptcy Code thus prevent the Service from using a tax refund due the debtor as a setoff against a pre-bankruptcy liability unless the bankruptcy court grants relief from the stay. Of course, the Government could argue that it has a secured claim, that it is entitled to a right of setoff under 11 U.S.C. § 553, and could ask for a lifting of the automatic stay under 11 U.S.C. § 362(d). Furthermore, the refund constitutes cash collateral (11 U.S.C. 363(a)). Under 11 U.S.C. § 363(c)(2), the debtor

"may not use, sell, or lease cash collateral . . . unless-
(A) each entity that has an interest in such cash collateral consents; or
(B) the court, after notice and a hearing, authorizes such use, sale or lease . . ."

Under the circumstances, we suggest that steps be taken to have so much of the tentative NOL carryback paid to the bankruptcy court (or under bankruptcy court

supervision). To protect it's interest, the SEC should file a proof of claim with the bankruptcy court.[4] The General Litigation Division is prepared to work with you and provide whatever advice and guidance you may require in this regard.

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By: _____
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Enclosures:
GCM 25,604
GCM 35,517
GCM 36,521
GCM 39,318
CC Memorandum dated June 2, 1982

[4] Under I.R.C. § 6103(l)(10), the Service may disclose the fact of the tentative NOL carryback to the SEC if inquiry is made.